TRIGG DRILLING CO., INC.

IBLA 92-618 Decided March 21, 1997

Appeal from a decision of the Director, Minerals Management Service, denying an appeal from order assessing additional royalties. MMS-89-0014-O&G.

Affirmed in part, reversed in part.

1. Oil and Gas Leases: Royalties: Generally

Under the terms of NTL-5, 42 Fed. Reg. 22610 (May 4, 1977), prior to modification in 1986, the base value for royalty purposes of gas sold under an arm's-length transaction from wells commenced after June 1, 1977, was the higher of the price received by the lessee/ operator or the highest applicable ceiling price. In passing the Notice to Lessees Numbered 5 Gas Royalty Act of 1987, Congress mandated valuation of gas produced between Jan. 1, 1982, and the 1986 modification of NTL-5 in accordance with the valuation regulation at 30 C.F.R. § 206.103 (1983). Although the statutory ceiling price is one of the relevant factors, there is a presumption that a price negotiated at arm's length between a buyer and seller fairly reflects the market and an assessment of additional royalty on the basis of a ceiling price will be reversed in the absence of any evidence that this price does not adequately represent fair market value.

APPEARANCES: Hugh V. Shaefer, Esq., and Stephen M. Brainerd, Esq., Denver, Colorado, for Appellant; Geoffrey Heath, Esq., Office of the Solicitor, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE GRANT

Trigg Drilling Company, Inc. (Trigg), has appealed from the May 20, 1992, Decision of the Director, Minerals Management Service (MMS), denying its appeal from a December 8, 1988, Order of the MMS Royalty Compliance Division directing payment of $28,390.91 in additional royalties. The assessment was based on an audit of natural gas produced from the Browning Federal 1-12 Well on Federal Lease No. 048-20869-0. The audit, conducted by the Wyoming State Auditor's Office, covered the period January

1980 through December 1986. The additional royalties Trigg was ordered to pay involve production from September 1981 to December 1, 1984. As of that date, Trigg's interest was sold to Kaiser Energy, Inc., which assumed responsibility for payment of royalties arising from its period of ownership.

The well at issue was spudded in 1979 and began to produce gas in September 1981. This production was sold pursuant to a 1974 agreement between Trigg's predecessor-in-interest and Western Transmission Corporation (Western) at the ceiling price established by section 104 of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. § 3314 (1994) (repealed effective 1993). 1/ Production qualified for a higher price under section 103 of the NGPA, however. In April 1982 Trigg sought approval from the Federal Energy Regulatory Commission, successor to the Federal Power Commission (FPC), for such higher price and obtained that approval. Despite the eligibility of the gas for a higher section 103 price, Western was never charged a price above that authorized by section 104. Trigg paid royalty only on the amount received from Western rather than the amount that could have been charged under section 103. The MMS found that Trigg breached its duty to obtain the highest price for the Federal gas, having failed to make timely application to qualify the well for a higher ceiling price and for failing to obtain that price when the contract with its purchaser authorized sale at that price.

In its Statement of Reasons (SOR) for appeal to the Board, Trigg asserts that a statute of limitations, 28 U.S.C. § 2415 (1994), precludes collection of the additional royalties. Further, it is argued that Appellant is entitled to the benefit of a subsequently promulgated gas valuation regulation which Appellant contends allows payment of royalty on the basis of the proceeds of an arm's-length contract even if those proceeds are less than the ceiling price. Finally, Appellant asserts MMS erred in finding under the terms of the regulation in effect at the time of the gas sales that the statutory ceiling price represents the value of the gas when Appellant was unable to sell the gas at that price.

The MMS responds that the 6-year statute of limitations at 28 U.S.C. § 2415(a) (1994) for commencement by the United States of civil actions for damages does not apply to administrative proceedings within the Department. Further, the MMS answer points out that the revised gas valuation regulations do not apply to gas production prior to the effective date of the regulations. On the substance of the valuation issue, MMS contends that, during the period in question, under Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases No. 5 (NTL-5), 42 Fed. Reg.

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1/ Section 2(b) of the Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 Stat. 158. This statutory provision repealed the wellhead price control provisions of the NGPA, 15 U.S.C. §§ 3311-3333 (1994), effective Jan. 1, 1993.

22610 (May 4, 1977), and the regulations at 30 C.F.R. § 221.110 (1980) (recodified as 30 C.F.R. § 206.103 (1983)) production from wells subject to an arm's-length contract is properly valued for royalty purposes at the higher of the gross proceeds under the contract or the highest applicable ceiling price. The MMS argues that Trigg's contract with Western authorized sale at the highest applicable ceiling price and that Trigg has not shown that reasonable business judgment was used in selling the gas at a lower price.

As a threshold matter, Appellant's contentions regarding application of the statute of limitations and retroactive application of the 1988 gas valuation regulations are properly rejected. Appellant's argument that the MMS claim for royalty underpayments is barred under 28 U.S.C. § 2415 (1994) is one we have repeatedly rejected as inapplicable in the context of administrative appeals. See, e.g., Texaco Exploration and Production, Inc., 134 IBLA 267 (1995), and cases cited therein. 2/ With respect to retroactive application of the 1988 regulations, the Board has recognized that the regulations only apply to production prospectively. Exxon Company, U.S.A., 121 IBLA 234, 251 (1991), reaffirmed (On Reconsideration), 121 IBLA 252A (1992); BWAB, Inc., 108 IBLA 250, 257 n.2. (1989); Revision of Gas Royalty Regulations and Related Topics, Final Rule, 53 Fed. Reg. 1230 (Jan. 15, 1988). While, in the absence of any intervening rights which would be adversely affected or countervailing public policy considerations, we have applied amended regulations retroactively to the benefit of an appellant where this was not contrary to the explicit scope of the amended regulations, 3/ this principal is inapplicable in this case. First, the revised regulations are explicitly made applicable only to production after March 1, 1988. Further, the potential reduction of royalties payable to the Federal lessor would constitute a countervailing public policy consideration and the interest of the State of Wyoming in a portion of those royalties would constitute an intervening third-party right.

Resolution of the royalty valuation issue in this case is aided by an understanding of the statutory and regulatory background of NTL-5. The relevant regulation regarding royalty valuation at the time of the gas sales in question provided that:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product * * * due consideration being given to the highest price paid for a part or for a majority of production of like quality in

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2/ For royalty obligations becoming due after August 1996, recently passed legislation provides that a demand "shall be commenced within seven years from the date the obligation becomes due and if not so commenced shall be barred." Federal Oil and Gas Royalty Simplification and Fairness Act of 1996, Pub. L. No. 104-185, § 115(b), 110 Stat. 1705.
3/ See Exxon Corp., 95 IBLA 165, 175 (1987); Willard Pease Oil & Gas Co., 89 IBLA 236 (1985).

> the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof * * *. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

30 C.F.R. § 206.103 (1983) (formerly codified at 30 C.F.R. § 221.110).

In recognition of the increasing value of natural gas, the Department promulgated NTL-5 in 1977. Issued pursuant to the oil and gas operating regulations at 30 C.F.R. § 221 (including the regulation above-quoted, at 30 C.F.R. § 221.110), the Department ruled in NTL-5 that the base value for royalty purposes for sales under an arm's-length transaction from wells commenced after June 1, 1977, "shall be the higher of: a. The price received by the lessee or operator in accordance with the provisions of the applicable sales contract, or b. The highest applicable ceiling rate then established by the FPC for the same vintage gas." 42 Fed. Reg. 22610 (May 4, 1977).

This rule, promulgated to protect the lessor's royalty interest in a time of rising gas prices, posed certain problems when gas prices subsequently declined, causing MMS to find that "unintended disparities between the royalty value of gas and its market value have been created." 51 Fed. Reg. 260, 261 (Jan. 3, 1986). Hence, MMS proposed a modification of NTL-5 to allow MMS to "consider the changing natural gas market in valuing natural gas for royalty purposes" and to permit it to redetermine royalty in light of the other factors in the regulation at 30 C.F.R. § 206.103 in order to "ensure that the value for royalty purposes reflects market conditions." Id. at 261. Although the proposal noted that MMS was considering retroactive application of the revision, the published modification of NTL-5 was made applicable prospectively only. 51 Fed. Reg. 26759, 26765 (July 25, 1986). The MMS again proposed modifying NTL-5 retroactively in 1987, noting that application of NTL-5 to royalty obligations arising from May 1, 1982, to August 1, 1986, "may result in the establishment of royalty values for some gas production which could be considered to be unreasonable." 52 Fed. Reg. 1671 (Jan. 15, 1987). This proposed regulatory change was never promulgated in rulemaking.

Thereafter, Congress effectuated by statute that which the Department failed to accomplish by rulemaking. For Federal onshore gas produced between January 1, 1982, and July 31, 1986, Congress provided that valuation for royalty purposes shall be "the reasonable value of the product as determined consistent with the lease terms and the regulations codified at part 206 of title 30, Code of Federal Regulations, in effect at the time of production." Notice to Lessees Numbered 5 Gas Royalty Act of 1987 (NTL-5 Act), Pub. L. No. 100-234, § 3(b), 101 Stat. 1719, 1720 (1988). This gave MMS the discretion to decline to apply the provisions of NTL-5 arbitrarily when this would not reflect the reasonable value of the gas. 4/ The statute noted, however, at section 3(d) that this provision did not

> apply to any gas for which, in the Secretary's judgment, the lessee or royalty payor received less that the highest applicable price under the Natural Gas Policy Act due to a failure by the lessee or payor to collect amounts which the purchaser would have been required to pay under a gas sales contract providing for that price and not as a result of market conditions or considerations.

101 Stat. 1721.

The MMS decision from which this appeal is brought held that from January 1, 1982, through July 31, 1986, gas valuation is dictated by the NTL-5 Act. Finding that the regulated price is one of the relevant matters to be considered when determining the value of the gas under the regulation at 30 C.F.R. § 206.103 (1983), the MMS decision held that valuation of the gas was properly found to be the section 103 ceiling price under the terms of NTL-5 as promulgated in 1977. The MMS found that the statutory modification of the NTL-5 valuation standard did not apply to the production in this case. This finding was not based on any determination of the price of gas produced from the field or on any provision of the statute, but rather upon the potential effective dates for a modification of NTL-5 published by MMS 5/ in one of the proposed modifications of NTL-5 which was never promulgated. As stated above, MMS has abandoned this basis for application of the NTL-5 ceiling price on appeal, asserting rather that Appellant has not

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4/ This legislation was explicitly predicated on a finding that:

"[A]lthough between 1982 and 1986 gas prices in many areas declined below the maximum lawful prices established under the Natural Gas Policy Act of 1978, the continued application of NTL-5 required some royalties to be paid on the basis of a ceiling rate higher than the market value for the gas."

NTL-5 Act, Pub. L. No. 100-234, § 1(b)(4), 101 Stat. 1719. As a result, Congress found that:

"[T]he failure to adjust the method of calculating royalty payments resulting from changes in the gas market created various problems in valuation, produced inequitable situations for many lessees and payors whose gas market price was well below the [NGPA] ceiling prices, and created uncertainty associated with the collection of royalty revenues. Uniform application of [NGPA] ceiling prices was inequitable given market conditions during this period. For these reasons, it is necessary and appropriate for the Congress to provide for certain adjustments through legislation."

NTL-5 Act, Pub. L. No. 100-234, § 1(b)(8), 101 Stat. 1720.

5/ 52 Fed. Reg. 1671 (Jan. 15, 1987). In this proposal, the modification of NTL-5 would have been made effective Jan. 1, 1985, for § 103 gas.

shown reasonable business judgment was used in selling the gas at a price lower than the ceiling price authorized in the sale contract.

[1] Notwithstanding the Decision of MMS below, it is clear that in passing the NTL-5 Act Congress directed the Department to determine the value of Federal onshore gas produced between January 1, 1982, and July 31, 1986, 6/ in accordance with the valuation regulation at 30 C.F.R. § 206.103 (1983). The regulated ceiling price under the NGPA is one of the relevant factors to be considered in valuing gas under this regulation. See FMP Operating Co., 121 IBLA 328, 331 (1991); Phillips Petroleum Co., 117 IBLA 230, 233 (1990); Mobil Oil Corp., 115 IBLA 304, 310 n.7 (1990). Further, the fact that the lessee failed to diligently apply for certification to obtain the highest ceiling price in a timely manner and received a lower price in the interim will not preclude valuation for royalty purposes at the ceiling price for which the gas is found to be eligible. See FMP Operating Co., supra at 331-32; Mobil Oil Corp., supra at 309-10. 7/ If the lessee was receiving less than the maximum ceiling price allowed under the NGPA, then valuation may properly consider the maximum Federal ceiling price. Id. Applying these principles, we find that Appellant has not denied the eligibility of the gas for section 103 prices for production from September 1981 through April 1982 when application for approval was belatedly filed. It was not until this application was made and Appellant entered negotiations with the buyer and sought, ultimately unsuccessfully, to obtain this price that the presumptive value was established as lower than the ceiling price. Accordingly, we find that the decision below must be affirmed as to valuation of production from September 1981 through April 1982.

Insofar as the period subsequent to April 1982 is concerned, it must be recognized that claims for royalties in excess of sale proceeds for failure to obtain the regulated ceiling price are subject to the defense that the lessee exercised reasonable business judgment. See Transco Exploration Co., 110 IBLA 282, 327 (1989). In explaining the circumstances of the failure to obtain the section 103 ceiling price, Appellant relates that:

> In 1982, when Trigg first considered obtaining § 103 qualification for Browning Well gas, it notified Western of its intentions. Western flatly refused to pay anything above a price equivalent to that prescribed by § 104, which was the

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6/ The statute did not modify NTL-5 as to gas produced prior to Jan. 1, 1982. The statute did, however, explicitly find that NTL-5 was a duly promulgated rule of the Interior Department within the meaning of the Administrative Procedure Act, 5 U.S.C. § 553 (1994).
7/ In a case involving the valuation of gas for royalty purposes under state law, the court held that the value of regulated gas is properly based on comparable sales of gas with the same legal characteristics and subject to the same price restraints of the relevant category of the NGPA. Bowers v. Phillips Petroleum Co., 692 F.2d 1015, 1020 (5th Cir. 1982).

> price applicable to most of its purchases from Trigg. After the economic concerns of both parties had been discussed at length, Trigg accepted a price equal to the § 104 level for all production sold from the Browning Well. Thus, the rate settled upon by Trigg and Western constitutes an amendment to the pricing provision of the 1974 American Quasar/Western Transmission Gas Purchase Agreement. The amendment was reached at arm's-length by two completely unrelated corporate entities.

(Supplemental SOR at 3.) In discussing the impact on valuation resulting from prices reduced by arm's-length 8/ negotiation between buyer and seller, we have noted that there is a presumption "that the price obtained fairly reflects the marketplace," although this does not preclude the Department "from determining that the new negotiated price does not adequately represent fair market value and requiring the lessee to submit royalty payments on a higher value basis than is actually obtained." Transco Exploration Co., supra at 322. In situations where the sale at a price less than the ceiling price was the result of arm's-length negotiations between buyer and seller, valuation at the ceiling price cannot be sustained in the absence of evidence under other regulatory indicia that the ceiling price represented the reasonable value of gas produced from the field. No such evidence is found in the record in this case. Thus, for example, there is no evidence of the highest price paid or offered at the time of production in a fair and open market for the major portion of like-quality gas produced and sold from the field or area where the leased lands are situated. See 30 C.F.R. § 206.103 (1983). In these circumstances, we find that the MMS decision must be reversed as to the valuation of production for the months of May 1982 through November 1984.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the decision appealed from is affirmed in part and reversed in part.

C. Randall Grant, Jr.
Administrative Judge

I concur:

James L. Burski
Administrative Judge

8/ A sale at arm's length has been held to connote "a sale between parties with adverse economic interests." AMAX Lead Co. of Missouri, 84 IBLA 102, 107 (1984), quoting, Campana Corp. v. Harrison, 114 F.2d 400, 408 (7th Cir. 1940), overruled on other grounds, F.W. Fitch Co. v. United States, 323 U.S. 582 (1945).